

**STATE BAR OF CALIFORNIA
TAXATION SECTION
TAX PROCEDURE AND LITIGATION COMMITTEE**

**VALIDATING THE INVALID: WHY INTERNAL REVENUE CODE
SECTION 6226(h) SHOULD BE AMENDED**

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¹ The comments contained in this paper are the individual views of the author(s) who prepared them, and do not represent the position of the State Bar of California or of the Los Angeles County Bar Association.

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EXECUTIVE SUMMARY

Internal Revenue Code Section 6226 governs judicial review of final partnership administrative adjustments (“FPAA”).³ Section 6226(a) provides that within ninety days after the day on which a notice of an FPAA is mailed to the tax matters partner, the tax matters partner may file a petition for a readjustment of the partnership items for such taxable year with (1) the Tax Court, (2) the district court of the United States for the district in which the partnership’s principal place of business is located, or (3) the Court of Federal Claims.⁴ If no petition is filed, the partners have no other opportunity to contest the merits of the partnership adjustments. Section 6226(h) provides that “[i]f an action brought under this section is dismissed (other than under paragraph (4) of subsection (b)), the decision of the court dismissing the action shall be considered as its decision that the notice of final partnership administrative adjustment is correct, and an appropriate order shall be entered in the records of the court.”⁵ Taken literally, a dismissal other than for priority of claims under Section 6226(b)(4), is automatically a decision that the FPAA is correct. Thus, even an invalid FPAA could effectively be determined to be correct if a partner filed a Section 6226 action in order to contest the validity of the FPAA and obtained a dismissal of the action based on lack of jurisdiction.

The legislative history to Section 6226 states that any dismissal “*other than based on lack of jurisdiction*” is a decision that the FPAA is correct.⁶ That limitation did not appear in the actual statute as enacted, yet there is no evidence that this omission was the result of a policy determination. Litigators are wary of moving to dismiss, and knowledgeable representatives will try to ensure that appropriate language is included in the court’s order.

Based on the foregoing, the authors suggest that Section 6226(h) be amended to include the limiting language from the legislative history in those cases where a court’s lack of jurisdiction is due to an invalid FPAA. Alternatively, the authors suggest the issuance of a regulation to clarify the matter.

³ Unless otherwise indicated, all “Section” references are to the Internal Revenue Code of 1986, as amended (“IRC”), and the Treasury Regulations promulgated thereunder.

⁴ IRC §6226(a).

⁵ IRC §6226(h).

⁶ Pub. L. No. 97-248, section 402(a), 96 Stat. 324 (1982) (emphasis added).

DISCUSSION

I. BRIEF BACKGROUND

In 1982, as part of the Tax Equity and Fiscal Responsibility Act (“TEFRA”),⁷ Congress enacted the unified partnership audit examination and litigation provisions of the IRC which are currently found in Sections 6221-6234. Prior to TEFRA’s enactment, the Internal Revenue Service (“IRS”) audited partnership return items at the partner level. Due to the flow-through nature of a partnership’s income and expenses to the individual partners, multiple proceedings were required to address the tax treatment of partnership items for each partner. The enactment of the unified partnership audit examination and litigation provisions created a streamlined procedure and centralized the treatment of partnership items.

Under TEFRA, the IRS must notify partners of the beginning and end of partnership-level administrative proceedings. In particular, the IRS must send notice of an FPAA resulting from a partnership level administrative proceeding.⁸ Upon the issuance of an FPAA, the tax matters partner, who is a person or entity designated as such by the partnership under applicable regulations or, most commonly, the general partner with the largest profit stake in the partnership, may within ninety days after the date on which the FPAA is mailed, obtain judicial review of the FPAA by filing a petition for readjustment of partnership items in Tax Court, the Court of Federal Claims or the federal district court for the district in which the partnership’s principal place of business is located.⁹ If no such petition is filed by the tax matters partner within the ninety-day period, any notice partner or five-percent group may file a petition within the next sixty days.¹⁰ Any partner with an interest in the outcome of the proceeding is entitled to participate in an action brought by the tax matters partner or a notice partner.¹¹ If no petition is filed in response to the FPAA within the applicable time periods, the opportunity to contest the merits of the partnership adjustments is lost. Thereafter, a partner may only pursue a refund action and even then can only dispute the computational issues arising from the partner’s allocable share of

⁷ Pub. L. No. 97-248, 96 Stat. 324 (1982).

⁸ IRC §6223(a)(2).

⁹ IRC §6226(a).

¹⁰ IRC §6226(b).

¹¹ IRC §6226(c).

the partnership adjustments and/or partner-level defenses to penalties.¹² Thus, a partner does not have the option of defaulting on an FPAA and raising the issue of an invalid FPAA in a subsequent refund proceeding.

While the enactment of TEFRA has greatly simplified the audit examination and litigation procedure for partnership return items, partners may still face a conundrum when they seek judicial review of an FPAA under Section 6226 and move to dismiss for lack of jurisdiction because the FPAA is invalid. Section 6226(h) states that “[i]f an action brought under this section is dismissed (other than under paragraph (4) of subsection (b)), the decision of the court dismissing the action shall be considered as its decision that the notice of final partnership administrative adjustment is correct, and an appropriate order shall be entered in the record of the court.”¹³ Taken literally, under this rule it appears that a dismissal of even an invalid FPAA would operate as a decision that the FPAA is correct. Presumably, an invalid FPAA would not be sufficient to invoke the court’s jurisdiction, yet a dismissal of an action brought in response to such an invalid FPAA would effectively “bless” the adjustments in the invalid FPAA and assessment and collection could proceed. This presents practitioners and the courts with a result that both defies logic and contradicts the legislative history of Section 6226(h).

II. ANALYSIS OF SECTION 6226(h) AND RELATED ISSUES

A. Legislative History of Section 6226(h).

The legislative history to Section 6226(h) states that “[d]ismissal of an action *other than a dismissal for lack of jurisdiction*, shall be considered a decision that the FPAA is correct.”¹⁴ However, the limitation stated in the legislative history to Section 6226(h) does not appear in the actual statute as enacted. Indeed, as enacted, Section 6226(h) states in relevant part that “if an action brought under this section is dismissed (other than under paragraph (4) of subsection (b)), the decision of the court dismissing the action shall be considered as its decision that the notice of final partnership administrative adjustment is correct.”¹⁵ Paragraph (4) of subsection (b) pertains to dismissals of other actions based on another

¹² IRC §§6230(c), 6230(c)(4).

¹³ IRC §6226(h).

¹⁴ Pub. L. No. 97-248, section 402(a), 96 Stat. 324 (1982) (emphasis added).

¹⁵ IRC §6226(h).

petition's filing priority.¹⁶ Therefore, the only exception under Section 6226(h) is for a dismissal based on a petition's filing priority, not for "a dismissal for lack of jurisdiction" as contemplated in the legislative history. There is no evidence that explains this omission or that indicates that it was the result of a policy determination.

B. Jurisdictional Requirements for Filing a Section 6226 Action.

The principal jurisdictional requirements for filing a Section 6226 action contesting an FPAA are: (1) a validly issued FPAA; (2) a timely petition; and (3) if the petition is filed in the Court of Federal Claims or a federal district court, the deposit of an amount equal to the proposed adjustment of tax for the petitioning party.¹⁷ Therefore, a TEFRA action could potentially be dismissed for lack of jurisdiction based on three different grounds. The timely petition and deposit requirements pertain to responsibilities of a petitioning taxpayer. No inequity arises in the case of a dismissal due to an untimely petition or failure to satisfy the deposit requirement for petitions filed in a federal district court or the U.S. Court of Federal Claims. It is the taxpayer who bears the responsibility of filing a timely petition, and, appropriately, bears the consequences of an untimely petition. A petition that is dismissed for being untimely essentially has the same effect as a "no contest," i.e., if no petition is filed within the relevant sixty- and ninety-day periods, the opportunity to contest the partnership item adjustments in the FPAA is lost.¹⁸ Further, it is also the taxpayer who chooses to file a petition in a federal district court or the Court of Federal Claims and accordingly, subjects itself to the extra jurisdictional requirement of paying a deposit.¹⁹

¹⁶ See IRC §6226(b)(4). See also, e.g., Klamath Strategic Investment Fund LLC v. U.S., 96 AFTR 2d 2005-6912, 2005-13 (2005) (noting that because dismissal was under statute's multiple petition rule, i.e., Section 6226(b)(4), it would not result in Section 6226(h) adjudication on correctness of subject adjustments).

¹⁷ See, e.g., Rule 240, paragraph (c) for the jurisdictional requirements for filing a petition in Tax Court. For the jurisdictional requirement of making a deposit to bring an action in a federal district court or the U.S. Court of Federal Claims, see IRC §6226(e) and Treas. Reg. §301.6226(e)-1(a)(1).

¹⁸ A partner may contest the computational issues, but not the substantive FPAA adjustments, in an IRC §6230(c) refund procedure. However, a partner may be able to raise substantive issues in a bankruptcy action where the issues were not actually adjudicated previously. Central Valley Ag Enterprises v. U.S., 531 F.3d 750 (9th Cir. 2008).

¹⁹ Courts may show leniency in enforcing the deposit requirement. See, e.g., Span Hansa Management Co. v. U.S., 71A AFTR 2d 93-3648 (1991) (allowing tax matters partner who failed to fully pre-pay amount of taxes at issue, but who made a good faith effort to satisfy the deposit, to deposit amount owed to the IRS).
Footnote continued on next page

On the other hand, the requirement of a validly issued FPAA pertains to a responsibility of the IRS. The taxpayer has no control over whether the IRS issues a valid FPAA. When the IRS issues an invalid FPAA, it can lead to paradoxical and unfavorable results for a taxpayer. Because there is no refund forum for contesting the substantive partnership determinations in an FPAA other than by filing an action under Section 6226, the taxpayer has little choice but to file such an action as a protective measure. The taxpayer is thus “caught between a rock and a hard place,” whereby failure to file a petition under Section 6226 will cause the adjustments in the FPAA to become final, but filing a petition and having it dismissed will be viewed, under Section 6226(h), as the court’s determination that the adjustments in the FPAA are correct. Because of the potential inequity to taxpayers that can arise from a dismissal based on lack of jurisdiction due to an invalid FPAA, this paper will focus on the issues surrounding the specific jurisdictional requirement of a validly issued FPAA.

In recent years, the concern over the effect of Section 6226(h) has arisen most commonly as a result of the IRS’ decision to issue both a notice of deficiency to an individual partner and an FPAA to the partnership as a protective measure in situations where it was not clear to the IRS whether the adjusted items were in fact partnership items. Understandably, taxpayers typically respond by filing petitions in response to both the FPAA and the notice of deficiency. If it is determined that the adjustments in the FPAA relate to non-partnership items, then the FPAA would be invalid and the action would be dismissed for lack of jurisdiction, raising the possibility of a paradoxical result under Section 6226(h).

1. *Standard to Determine the Validity of an FPAA.*

Like a notice of deficiency, an FPAA gives the taxpayer the right to petition the Tax Court. The standard for determining the validity of an FPAA is whether the FPAA provides adequate or minimal notice to the taxpayer that the IRS has finally determined adjustments to the partnership return.²⁰ The Tax Court analyzes the effect of errors in an FPAA in the same

within ninety days to avoid dismissal of petition for readjustment of partnership taxes for lack of jurisdiction).

²⁰ Chomp Associates v. Comm’r, 91 T.C. 1069, 1073 (1988); Triangle Investors Ltd. Partnership v. Comm’r, 95 T.C. 610, 613 (1990).

way it analyzes errors in a notice of deficiency.²¹ Certain errors do not invalidate the notice of deficiency or FPAA if the taxpayer was not misled by the error.²² In a recent case, the IRS moved to dismiss a partnership action for lack of jurisdiction based on an argument that the FPAA was invalid and thus did not confer jurisdiction on the Tax Court.²³ There, the FPAA upon which the Tax Court petition was based was issued for a non-existent taxable year of the partnership. The IRS argued that the reference to the erroneous taxable year was intentional, rather than a typographical error. The Tax Court determined that the FPAA was valid because the erroneous taxable year referenced in the FPAA was a typographical error and did not mislead the taxpayer.

An example of an FPAA failing to meet the adequate or minimal notice standard is found in *Garner v. Commissioner* (“*Garner*”).²⁴ In *Garner*, the court was called upon to determine the validity of an FPAA sent by the IRS by certified mail to the taxpayer’s address in New Zealand.²⁵ Although the FPAA was sent by certified mail, it was not entitled to a presumption of delivery because U.S. postal regulations prohibit the use of certified mail to send letters abroad.²⁶ Therefore, the IRS assumed the risk of nonreceipt when it attempted to mail the FPAA to a foreign address by certified mail.²⁷ Further, based on the taxpayer’s credible testimony that he did not receive the FPAA, the court held that the FPAA was invalid as it related to the taxpayer (because an FPAA that was not received due to the fault of the IRS could not give minimal notice). Accordingly, the court determined that it lacked jurisdiction over the proceeding, and an order of dismissal was entered.²⁸

Presumably, because the action was dismissed for a reason other than the filing priority of actions under Section 6226(b)(4), under Section 6226(h), the decision of the court dismissing the action would

²¹ See *Sealy Power, Ltd. v. Comm’r*, 46 F.3d 382, 386 (5th Cir. 1995), *affg. in part and revg. in part*, on another ground, T.C. Memo. 1992-168.

²² *St. Paul Bottling Co. v. Commissioner*, 34 T.C. 1137 (1960) (error concerning taxable period at issue). See also, e.g., *Anderten v. Comm’r*, T.C. Memo. 1993-2 (references to wrong taxable year in explanation did not invalidate notice); *Erickson v. Comm’r*, T.C. Memo. 1991-97 (when taxpayer receives single document including a cover letter and explanatory statements, Tax Court looks to the entire document to determine whether the taxpayer could have been misled).

²³ *Petaluma FX Partners, LLC, et al. v. Comm’r*, T.C. Memo. 2007-254.

²⁴ *Garner v. Comm’r*, T.C. Memo 1996-37 (1996).

²⁵ *Id.*

²⁶ *Id.* at 96-361.

²⁷ *Id.*

²⁸ *Id.* at 96-361-62.

be considered as its decision that the FPAA was correct. The *Garner* case illustrates the difficult decision taxpayers may be forced to make when contesting an invalid FPAA. When confronted with an invalid FPAA, it seems logical that taxpayers would file a petition and then seek a dismissal of the action based on the court's lack of jurisdiction. However, Section 6226(h) acts to effectively bless even an invalid FPAA. Moreover, in seeking dismissal, taxpayers must tread carefully and be creative in the particular language of the court's order of dismissal. This can be a trap for the unwary, particularly where a taxpayer is unrepresented.

2. *Practitioners Are Cognizant of the Potential For Paradoxical and Unfavorable Results.*

The potential for paradoxical and unfavorable consequences from a proper motion to dismiss an action for lack of jurisdiction has been recognized by practitioners.²⁹ For example, in *Petaluma FX Partners, et al. LLC v. Commissioner* (“*Petaluma*”), the IRS filed a motion for summary judgment asserting that the court had jurisdiction over certain issues raised by the FPAA because they all related to partnership items.³⁰ The petitioner filed a cross-motion for summary judgment based on its stipulation to all of the partnership items adjusted in the FPAA.³¹ The petitioner claimed that it was entitled to summary judgment on certain remaining issues because the court lacked jurisdiction over such issues because they related to nonpartnership items.³² A footnote to the court's opinion noted that the “Petitioner did not file a motion for dismissal because sec. 6226(h) provides that a ‘decision of the court dismissing the action shall be considered as its decision that the notice of final partnership administrative adjustment is correct.’”³³ Given the way the petitioner crafted its motion in *Petaluma*, it is clear that it recognized the potentially harsh results of Section 6226(h) when an action is dismissed for lack of jurisdiction.

²⁹ Further, it should be noted that this potential for paradoxical and unfavorable results has also been recognized by academia. See, e.g., MCKEE, NELSON & WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS, ¶ 10.04, n.252 (stating that “[c]aution must be exercised because a jurisdictional dismissal may be treated as a determination that the FPAA is correct. For example, in the case of an invalid FPAA, a decision of no adjustment should be entered, rather than a jurisdictional dismissal.”).

³⁰ *Petaluma FX Partners, et al. LLC v. Comm’r*, 131 T.C. No. 9, 54-55 (2008).

³¹ *Id.* at 55.

³² *Id.*

³³ *Id.* at n.5.

C. Section 6226(h) and the Statute of Limitations.

Like practitioners, the Tax Court also apparently recognizes the potentially severe and unintended consequences of dismissing a Section 6226 action for lack of jurisdiction. In *Columbia Building, Ltd. v. Commissioner* (“*Columbia Building*”), the court was called upon to determine the consequences of the expiration of the statute of limitations due to an untimely FPAA.³⁴ In that case, it was agreed that the statute of limitations for assessment had expired because no FPAA was sent to the tax matters partner suspending the statute of limitations under Section 6229(d) before the period for assessment under Section 6229(a) had expired.³⁵ In its analysis, the court first looked to analogous deficiency cases. It noted that in deficiency cases, asserting the bar of the statute of limitations is an affirmative defense rather than a jurisdictional question.³⁶ Furthermore, under Section 7459(e), the Tax Court’s decision that assessment or collection of any tax is barred by the statute of limitations is considered as its decision that there is no deficiency.³⁷ The court determined that a similar rule should also apply in TEFRA partnership cases.³⁸ Otherwise, the court noted, “[a]n order simply dismissing the action would impermissibly bring section 6226(h) into play.”³⁹ This analysis demonstrates the court’s concern and recognition that Section 6226(h) can have very unfavorable and unintended consequences when a petition is dismissed for lack of jurisdiction. Indeed, the court noted that “if an order of dismissal were entered, the Court’s action could be misinterpreted as a decision that the FPAA is correct and the Commissioner may proceed toward assessment and collection of any tax related to partnership items.”⁴⁰ While *Columbia Building* and Section 7459(e) may provide some comfort for litigants in Tax Court where the FPAA was not issued within the statute of limitations, Section 7459(e) does not apply to decisions of the Court of Federal Claims or federal district courts. Moreover, the *Columbia Building* decision does not control where the FPAA is invalid for reasons other than simply being issued after the expiration of the statute of limitations. Consequently, despite the Tax Court’s decision in *Columbia Building*, taxpayers are still

³⁴ *Columbia Building, Ltd. v. Comm’r*, 98 T.C. 607, 611 (1992).

³⁵ *Id.*

³⁶ *Id.*

³⁷ *Id.* at 612.

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ *Id.*

subject to the severe consequences of Section 6226(h) in many other circumstances.

D. Analogous Provision to Section 6226(h) in Deficiency Cases.

The analogous provision to Section 6226(h) in deficiency cases is Section 7459(d), which governs the effect of a decision dismissing a petition for a redetermination of a deficiency. Under Section 7459(d), there is a specific exception for situations where the dismissal is for lack of jurisdiction.⁴¹ The legislative history to Section 6226(h), which states that a “[d]ismissal of an action *other than a dismissal for lack of jurisdiction*, shall be considered a decision that the FPAA is correct,”⁴² seems to reflect the “lack of jurisdiction” exception in Section 7459(d) for a decision dismissing a petition in deficiency cases. Further, it appears that the Tax Court is willing to look to analogous provisions in deficiency cases for purposes of deciding issues arising under TEFRA actions. As discussed above, in *Columbia Building*, when deciding the consequences of the expiration of the statute of limitations on a TEFRA action due to an untimely FPAA, the Tax Court looked to Section 7459(e), which applies in deficiency cases and governs the effect of a decision that a tax is barred by the statute of limitations.⁴³ Under Section 7459(e), when a deficiency notice has been mailed after the statute of limitations expired, the Court enters its decision of “no deficiency.”⁴⁴ The Tax Court believed that “the same approach should be taken in the context of a TEFRA partnership proceeding.”⁴⁵ In a similar manner, Section 7459(d), coupled with the legislative history to Section 6226(h), supports the proposition that Section 6226(h) should contain an exception for dismissals based on lack of jurisdiction.

⁴¹ See IRC §7459(d), which states that “[i]f a petition for a redetermination of a deficiency has been filed by the taxpayer, a decision of the Tax Court dismissing the proceeding shall be considered as its decision that the deficiency is the amount determined by the Secretary. An order specifying such amount shall be entered in the records of the Tax Court unless the Tax Court cannot determine such amount from the record in the proceeding, *or unless the dismissal is for lack of jurisdiction*” (emphasis added).

⁴² Pub. L. No. 97-248, section 402(a), 96 Stat. 324 (1982) (emphasis added).

⁴³ *Columbia Building, Ltd. v. Comm’r*, 98 T.C. 607, 611-12 (1992).

⁴⁴ See IRC §7459(e), which states that “[i]f the assessment or collection of any tax is barred by any statute of limitations, the decision of the Tax Court to that effect shall be considered as its decision that there is no deficiency in respect to such tax.”

⁴⁵ *Columbia Building, Ltd. v. Comm’r*, 98 T.C. 607, 612 (1992).

E. Administrative and Judicial Sensitivity to Potentially Harsh Results Under Section 6226(h).

When Section 6226(h) potentially applies to an action that is to be dismissed for lack of jurisdiction due to an invalid FPAA, it appears the courts and the IRS Office of Chief Counsel will work with the taxpayer and representatives to reach a fair and equitable result. An invalid FPAA is generally treated as a nullity, i.e., as if it never existed and no adjustments were made to partnership items. The parties must work with the court to include appropriate language in the court's order to the effect that "there are no adjustments to partnership items." Under that approach, there should be no resulting deficiency, assessment or collection.⁴⁶ While this may be welcome news to many, unfortunately it is not known to all taxpayers and there remains the possibility that the technical rule of Section 6226(h) will be rigidly applied leading to an unfair result. Furthermore, it is not only taxpayers who may bear the adverse consequences; it is not difficult to imagine circumstances under which the IRS could be the disadvantaged party. Until there is a clarifying change in the statute or other published guidance on the issue, both parties face uncertainty about the consequences of moving to dismiss a TEFRA action for lack of jurisdiction.

III. CONCLUSION

As enacted, Section 6226(h) can lead to paradoxical and unjust results when a Section 6226 action is dismissed for lack of jurisdiction based on an invalid FPAA. In the extreme, it is possible for either party to engineer a favorable result based on the technical operation of the rule under Section 6226(h) that any dismissal based on lack of jurisdiction is considered to be the court's decision that the adjustments in the FPAA are correct. This provision requires the parties and the courts to craft motions and dispositive orders carefully to avoid unintended results where a case is to be dismissed. The legislative history to Section 6226(h) clearly shows that an exception for a dismissal based on lack of jurisdiction was intended for such provision. For these reasons, Section 6226(h) should be amended to include language to carve out an exception for dismissals due to lack of jurisdiction. Such an amendment is not only in accord with the limiting language from the

⁴⁶ The fact that an invalid FPAA will be treated as a nullity previously appears to have been recognized indirectly by the IRS. See I.R.S. Field Ser. Adv. 2310 (Mar. 26, 1998), in which the issue was whether FPAA's issued by a person without delegated authority under Delegation Order 209 were valid. In concluding that the FPAA's were invalid, it was recommended that the agent move to dismiss for lack of jurisdiction the pending cases based on petitions to such FPAA's and that new FPAA's be issued.

legislative history, but would also provide practitioners and the courts with certainty and fairness in dealing with an invalid FPAA. Alternatively, we recommend the issuance of a regulation to clarify the matter.